

March 30, 2004

MEMORANDUM FOR ALL LMSB AND SB/SE EXECUTIVES, MANAGERS,
AND EXAMINERS

FROM: Deborah M. Nolan // *Deborah M. Nolan*
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Commissioner, Small Business/Self-Employed Business Division

SUBJECT: Section 41 Credit for Increasing Research Activities
(Research Credit): Current Audit Inventory Guidelines

Introduction:

This memorandum sets forth guidelines to be followed in research credit examinations, and supercedes the LMSB and SB/SE Commissioners' Administrative Guidance for Research Credit Cases issued on January 10, 2002 ("LMSB and SB/SE Commissioners' Administrative Guidance").

Background:

On December 31, 2003, Treasury and the IRS issued final regulations on the definition of qualified research under section 41(d) (T.D. 9104). T.D. 9104 amends certain provisions of the final regulations issued on January 3, 2001 (T.D. 8930). Although T.D. 9104 is applicable to taxable years ending on or after December 31, 2003, we will not challenge return positions consistent with T.D. 9104.

T.D. 9104 does not contain rules on the internal-use software exclusion under section 41(d)(4)(E). An advance notice of proposed rulemaking (ANPRM), issued by Treasury and the IRS on December 31, 2003, requests additional comments on the internal-use software exclusion and tells taxpayers what they may rely upon until final regulations are issued. See Announcement 2004-9, 2004-6 I.R.B. 441, 445. With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the Federal Register, the ANPRM states that taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362). Alternatively, taxpayers may continue to rely

upon all of the provisions relating to internal-use software in T.D. 8930 (66 FR 280). For example, taxpayers relying upon the internal-use software rules of T.D. 8930 must also apply the “discovery test” as set forth in T.D. 8930. Accordingly, we will not challenge return positions consistent with all of the provisions relating to internal-use software in the 2001 proposed regulations, or alternatively, all of the provisions relating to internal-use software in T.D. 8930, until further guidance is published in the Federal Register.

Provisions of T.D. 8930 not addressed in T.D. 9104 (e.g., the definition of gross receipts) retain the effective dates set forth in T.D. 8930, generally January 3, 2001.

Current Audit Inventory Guidelines:

In light of the above, the following guidelines apply where audit resources are currently allocated to research credit issues.

A. Business Components Other Than Internal-Use Software

1. For ongoing audits where a Form 5701 or a Form 4549 has been prepared in accordance with the January 10, 2002 LMSB and SB/SE Commissioners’ Administrative Guidance, there is no need to amend your determination as T.D. 9104 merely clarifies the December 26, 2001 proposed regulations.
2. For all other ongoing audits, you should ensure that research credit issues are developed in accordance with the rules set forth in T.D. 9104.

B. Internal-Use Software

1. For ongoing audits where a Form 5701 or a Form 4549 has not yet been prepared and the taxpayer is not relying upon either all of the provisions relating to internal-use software in T.D. 8930 (including the discovery test) (66 FR 280), or alternatively, all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362), the examiner should ensure that internal-use software research credit issues are developed in accordance with all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362).
2. For ongoing audits where a Form 5701 or a Form 4549 has not yet been prepared and the taxpayer is relying upon either all of the provisions relating to internal-use software in T.D. 8930 (including the discovery test) (66 FR 280), or alternatively, all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362), the examiner

should ensure that internal-use software research credit issues are developed in accordance with the guidance relied upon by the taxpayer.

If a taxpayer relies upon a position that selects among the provisions of the 2001 proposed regulations and T.D. 8930, however, the examiner should ensure that internal-use software research credit issues are developed in accordance with all of the provisions relating to internal-use software in the 2001 proposed regulations (66 FR 66362).

3. For ongoing audits where a Form 5701 or a Form 4549 has been prepared in accordance with the January 10, 2002 LMSB and SB/SE Commissioners' Administrative Guidance, there is no need to amend your determination as the ANPRM reaffirms our prior administrative practice.

This LMSB and SB/SE directive is not an official pronouncement of the law or the position of the Service and cannot be used, cited or relied upon as such. Any questions on the issues set forth in this memorandum should be referred to Lee Keenan, Research Credit Technical Advisor, at (781) 835-4309, or Dan Rosen, Research Credit Industry Counsel, at (917) 421-4645.

